

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLEE**

ORIGINAL
WITH PROOF
OF SERVICE

74-2405

United States Court of Appeals
FOR THE SECOND CIRCUIT

GERALD L. HERZFELD,
Plaintiff-Appellee,

—against—

LAVENTHOL KREEKSTEIN HORWATH & HORWATH,
Defendant-Appellant.

LAVENTHOL KREEKSTEIN HORWATH & HORWATH,
Third-Party Plaintiff-Appellee,

—against—

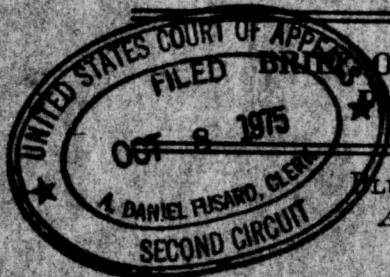
ALLEN & COMPANY, INCORPORATED and ALLEN & COMPANY,
Third-Party Defendants-Appellants.

ALLEN & COMPANY and ALLEN & COMPANY, INCORPORATED,
Third-Party Counter-claimants-Appellants,

—against—

LAVENTHOL KREEKSTEIN HORWATH & HORWATH,
Third-Party Counterclaim Respondent-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK



OF GERALD L. HERZFELD,
★ PLAINTIFF-APPELLEE ★

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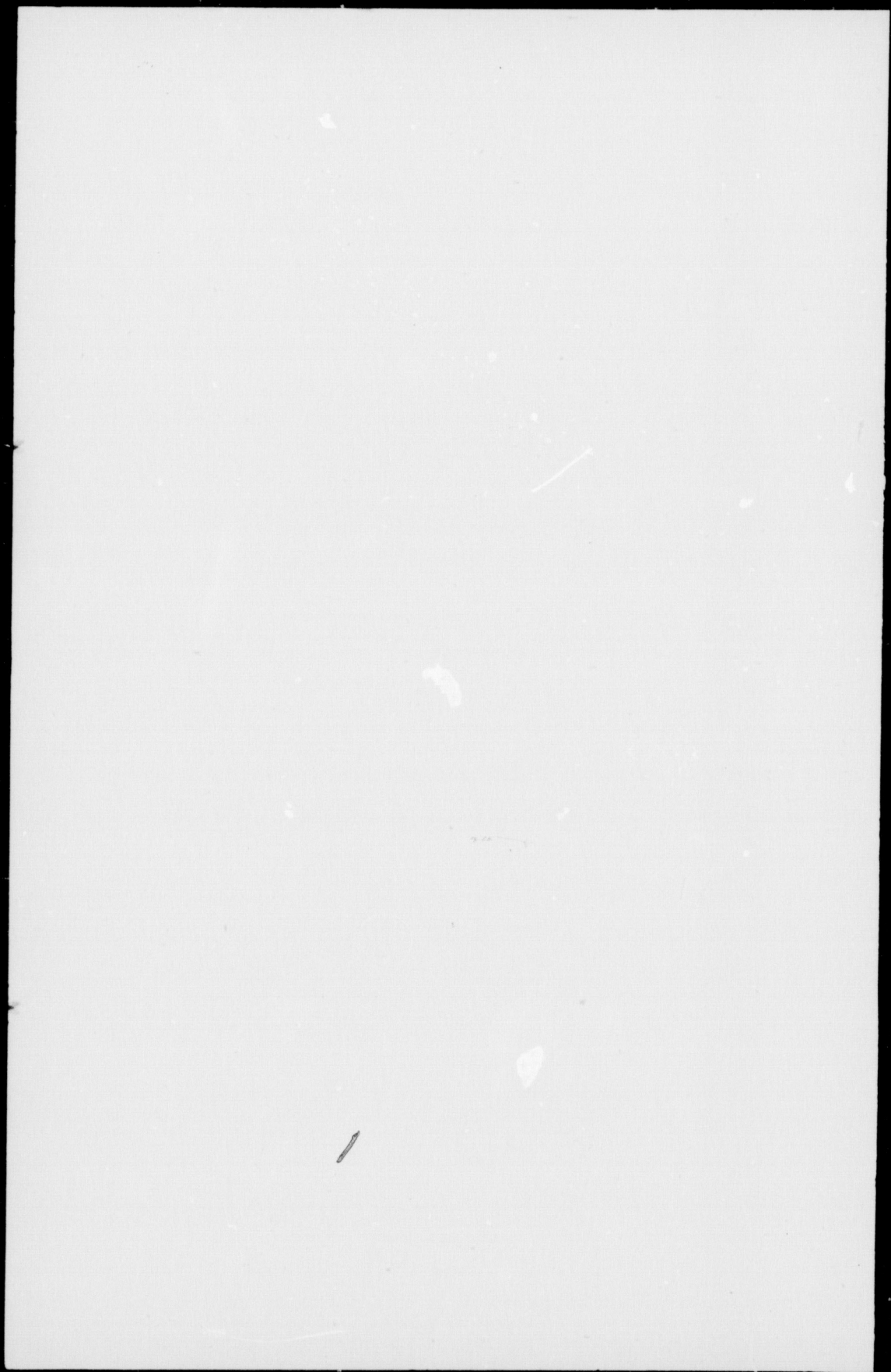


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United States Court of Appeals

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GERALD L. HERZFELD,

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—against—

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Defendant-Appellant.

LAVENTHOL KREKSTEIN HORWATH & HORWATH,

Third-Party Plaintiff-Appellee,

—against—

ALLEN & COMPANY, INCORPORATED and ALLEN & COMPANY,

Third-Party Defendants-Appellants.

ALLEN & COMPANY and ALLEN & COMPANY, INCORPORATED,

*Third-Party Counter-
claimants-Appellants,*

—against—

LAVENTHOL KREKSTEIN HORWATH & HORWATH,

*Third-Party Counterclaim
Respondent-Appellee.*

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF GERALD L. HERZFELD, PLAINTIFF-APPELLEE

Statement

Gerald L. Herzfeld ("Herzfeld"), plaintiff-appellee, submits this brief in answer to the brief of appellant Laven-

thol and in support of the amended judgment of the District Court in the Southern District of New York (MacMahon, *J.*) rendered after a trial without a jury, against Laventhol and in favor of Herzfeld in the amount of \$153,000 with costs and interest [1129a-1131a]*. The opinion of the District Court is reported at 378 F. Supp. 112.

Issues Presented**

1(a). Did the District Court correctly decide that the audit report of Laventhol which purported to present fairly the financial condition of Firestone Group, Ltd. ["FGL"] as of November 30, 1969 was false and misleading in that it included in Sales and Gross Profits, transactions evidenced by contracts executed in the last week of the accounting period, by which FGL contracted to purchase nursing homes for \$13.3 million dollars and to sell the properties for \$15.3 million dollars, though FGL never acquired nor conveyed title and FGL and Continental had made deposits of \$5,000 and \$25,000 respectively, and where Continental, which was obligated to pay \$4.9 million dollars in cash at the closing, had a net worth of \$100,000?

1(b). Did Laventhol sufficiently disclose the truth concerning the Monterey transactions by qualifying its certificate as being subject to the collectibility of the balance receivable under a contract of sale, referenced to Note 4 in its Report, when Note 4 stated that FGL had acquired and sold the properties, described the \$4.9 million dollars payable at the closing as "Cash", and did not disclose that Continental had a net worth of \$100,000 and also failed to

* References designated "a" are to Volumes I to IV and those designated "E" are to Volumes V and VI of the Joint Appendix.

** It is our view that the issues of law presented in the Laventhol Brief are not involved on this appeal. We set forth the issues of fact, resolved in plaintiff's favor, and the highlights of the pertinent proof, which we believe amply support the decision of the District Court.

disclose other facts bearing upon "the high level of contingency" and the "unusual uncertainties" which concededly characterized the Monterey transactions (Laventhol Br., p. 42)?

2. Did the District Court correctly hold that the requisite reliance and causation in fact was shown by proof that Herzfeld, though he did not read the qualified certificate nor Note 4, did read and rely upon the Income Statement which included \$235,000 in current profits, consisting of two payments of \$25,000, to be made by Continental, of which one was made, and \$185,000, payable by Continental as liquidated damages; and which labeled as "deferred gross profit" \$1,795,500 attributable to the Monterey sale, which signified to Herzfeld that this was a "profit the company had made and was going to pick up in a subsequent accounting period" [355a]?

3. Did the District Court correctly hold that the requisite *scienter* was shown on the part of Laventhol by proof that Laventhol had knowledge of the false statements made and of the material facts not disclosed; and its failure to disclose the facts known to it bearing upon the uncertainties of the Monterey transactions; and by the further proof that Laventhol had prepared and delivered to FGL a report, which was later superseded, and which described the profit allegedly attributable to the Monterey transactions as "unrealized income"; and included other information omitted from the later version of Note 4.

4. Though the District Court did not consider whether the financial statements as reported by Laventhol conformed to generally accepted accounting principles or were made in accordance with generally accepted auditing standards, does the record establish that the Report did not accord with generally accepted accounting principles and auditing standards?

5. Did the Court correctly hold that Laventhol was liable under common law?

6. Did the Court correctly hold that Laventhol was liable under Section 352-c of the New York General Business Law?

Statement of the Case

In view of the skeleton recital of the facts set forth in appellant's brief under the caption "Factual Background", augmented by its argumentative discussion of the evidence in the remainder of its brief, we submit herewith a detailed presentation of the facts relied upon by plaintiff.

The Facts

Initial Public Offering Aborts

For some years prior to 1968, FGL had been engaged in real estate syndications in California. Its business consisted of the acquisition of land and income-producing properties and the resale of the properties primarily through syndications [763a]. In 1968, Allen & Company, Inc. ("Allen"), a New York stock exchange and investment banking firm, became interested in FGL with a view to taking it "public" [720a, 764a]. The affairs of FGL were conducted by Richard M. Firestone as President [762a]; and after Allen had arranged preliminary private financing [720a], its directors were Firestone, Martin A. Scott, FGL's Vice President and a stockholder [547a], and Lee Meyer, an Allen Vice President [694a]. Allen's initial attempt in March, 1969 to take FGL public through a registered public offering [720a] proved abortive after the registration statement had been pending seven months; and a private placement was decided upon [719a, 721a].

The Private Placement

On November 13, 1969, the FGL directors approved an arrangement under which Allen, for a fee of \$200,000 was to effect a private placement of up to \$7,500,000 in 9½%

promissory notes and 150,000 shares of common stock, to be sold in units consisting of a \$250,000 note and 5,000 shares of stock at a price of \$255,000 for each unit [E353-4].

A Note and Stock Purchase Agreement (Purchase Agreement) dated November 10, 1969 was prepared [E7-E23] which, in 16 closely printed pages, described the securities and included as Exhibit B a balance sheet and income statement, which was warranted to be "correct and complete"; and to "fairly present the financial condition of the company and its subsidiaries as at November 30, 1969 and the results of their operations for the eleven months then ended, subject to audit and year end adjustments"; and to have been "prepared in accordance with generally accepted accounting practices" [E9].

Exhibit B Was Pure Fiction

Exhibit B portrayed a strikingly profitable operation—the balance sheet reported gross assets of \$20.2 million dollars; a net worth of \$981,666; and \$2.7 million dollars of "deferred income", consisting of \$788,000 in prepaid management fees and \$1.9 million dollars in prepaid interest; and the income statement recorded sales of \$17.7 million dollars, deferred income of \$2.7 million dollars, and after tax, net income of \$315,000 [E22-E23].

Adding impressive solidity to the \$2.7 million dollars in "deferred income" was a footnote comment that \$1,080,000 of income taxes on deferred income was "currently payable" [E23]; and even more persuasive was the statement in the Purchase Agreement that FGL intended to use a portion of the proceeds of the private placement to pay "approximately \$1,600,000" in "income taxes of the company" [E10].

At the trial Exhibit B was shown to be pure make believe. The dismal truth was that as of November 27, 1969, when FGL's books were closed, it had sustained an

operating loss of \$772,108 [E155]* on sales of \$6.7 million dollars [E120; 580a].

Paraphrasing the language of the Court in *Wessel v. Buhler*, 437 F. 2d 279 (9th Cir. 1971), Firestone, in preparing Exhibit B, had "picked" from the FGL books "the figures he found attractive" . . . and "discarded those he did not like and simply made up the rest. The result was fiction", * * * (p. 282).

Plaintiff's Investment

Plaintiff was introduced to the FGL investment by his friend, David Baird, a member of the firm of Baird, Patrick & Co., who reported to plaintiff that Charles Allen had described the Firestone investment as "one of the hottest deals he had ever seen" [284a]. Irwin Kramer, another friend of plaintiff, who was Charles Allen's son-in-law and an officer of Allen, was similarly enthusiastic about the FGL securities [309a]. Herzfeld, after talking with Baird and Kramer, was impressed by their enthusiasm [289a]. Though Baird was interested, he did not have the necessary funds and Herzfeld ultimately purchased two units under an arrangement with Baird by which Herzfeld would invest the \$510,000 required and would pay to Baird 25% of the profits on the Baird unit as compensation for Baird's services [E1-4].

Exhibit B to be Confirmed by Laventhol Audit

The Purchase Agreements forwarded to Herzfeld and Baird for execution, were accompanied by an FGL letter, dated November 21, 1969, stating that the closing

* The Court's finding that FGL's loss, excluding the Monterey transactions, was \$169,000 takes into account unrelated adjustments later made by Laventhol, which increased prepaid management fees by over \$140,000 and deferred costs of approximately \$500,000 [E139-E140].

was scheduled for December 16, 1969, "to permit the preparation of audited financial statements, as at and for the eleven months ended November 30, 1969, copies of which will be delivered to you" [E5]. The letter added that these "audited statements will serve as the basis for confirming the unaudited Projected Financial Statements annexed to the Note and Stock Purchase Agreement as Exhibit B" [E5]. The testimony further established that in the negotiations between Allen and FGL, it had been made "a condition" of the investment by Allen and its investors that "there had to be an audit statement" by "Laventhol" [810a, 811a].

Herzfeld testified that he "read both the balance sheet and the income statement" included in Exhibit B, and "paid particular attention to the income statement"; which indicated "that this was a very profitable company and earnings were approximately \$2 a share for the period ending November 30, 1969" [274a, 275a].

The Monterey Transaction—Telephone Calls to Laventhol Partners

At this point, Firestone had to structure a transaction which would authenticate the fictional Exhibit B. The Monterey purchase and sale was his solution—and he sought to pave the way by two preliminary telephone calls to Laventhol partners.

Arnold L. Lipkin, the Laventhol partner in charge of the audit, testified that he received a telephone call from Firestone while attending a convention in Monterey, California between November 9 and 12, 1969 [996a-997a]. Firestone said, "they were in the process of completing the sale of certain properties which they were acquiring"; he (Firestone) had been told by someone at Laventhol that "probably the profit of the sale would not be reflected in full on the income statement . . . and he felt somewhat exercised by that . . ." [996a]. Lipkin referred Fire-

stone to Laventhol's national partner for accounting, Charles Chazen, whose responsibility was to develop the firm's audit standards and "generally being the last word in accounting and auditing . . . for the entire national firm" [836a].

***Firestone's Telephone Call to Chazen From a
Beverly Hills Bar on November 20, 1969***

Chazen testified that on November 20, 1969, Firestone called him "from a bar in Beverly Hills" to say that "he had some idea in mind and wanted to discuss the accounting ramifications", which, as Chazen put it, had to do with "discussing accounting of a fictitious or proposed or artificial transaction" [887a].

The words "fictitious" and "artificial", used by Chazen in describing his conversation with Firestone, were either Freudian slips or a confession of guilt—either way, they accurately describe the Monterey transaction, which, as it soon turned out, was the "idea" that Firestone had in mind [887a].

***Chazen's Contemporaneous
"Options" Memorandum***

Critically significant on the central issue in the case (whether the Monterey purchase and sale were consummated transactions) was the contemporaneous memorandum prepared by Chazen of his conversation with Firestone (which apparently also included Lipkin) [886a]:

"T/C ALL [Lipkin's initials] option call with Dick Firestone."

Thus, Laventhol was clearly on notice at the outset that the Monterey transactions were options—not the consummated purchase and sale on which it reflected gross profit of \$2,030,500 and "deferred income" of \$1,795,500 [E34].

***The Amerson Memorandum of
November 21, 1969***

Firestone, apparently satisfied by his conversation with Chazen, that his "idea" would work, had an intra-office memorandum prepared on the following day by an employee, Donna Amerson, whose job with FGL was "processing of escrows" [569a]. This memorandum, dated November 21, 1969, recites: "We have entered into an agreement for the purchase of real property on a Contract of Sale" for \$10 million dollars; \$5,000 was to be paid on contract, \$25,000 on December 20, 1969 and the balance of \$2,970,000 on January 30, 1970 [E137-138]; and "we are selling the property at a profit of approximately 14% [\$1,400,000] . . . giving us a sales price of \$11,400,000"; the "cash we receive shall be the sum of \$3,700,000"; with \$25,000 payable on contract, \$25,000 on January 2, 1970, and the balance of \$3,650,000 on January 30, 1970 [F137-138].*

***The Monterey Purchase Contract
of November 22, 1969***

On the very next day, which was a Saturday, a purchase contract dated November 22, 1969, appears [E149-E154]. It was prepared under Firestone's supervision [810a] on a printed form; there were no attorneys; the contract covers 23 nursing homes located "in various counties and states as per Exhibit A attached hereto", but there is no Exhibit A; the transaction is subject to buyer and seller executing a NNN lease "per the terms and conditions of Exhibit D attached hereto", but there is no Exhibit D; and the purchase price which was \$10 million dollars, according to the Amerson memorandum [E137], had jumped to \$13,362,500. Further, the purchase was not

* This memorandum, which was in the Laventhol work papers, was received in evidence, not as proof of its contents, but as information known to Laventhol [1002a-1003a].

entered on the FGL books (neither Wadley, the controller, nor Scott, the Vice President, knew anything about it); and FGL's obligation to complete the transaction was dubious—under the contract, the “Buyer reserves the right at any time after 1/30/70 or upon payment of \$3,970,000 cash down payment as required herein to convert this contract of sale to a conventional sale at which time Title shall pass to Buyer” [E153].

Surely it was strange that this \$13.3 million dollar contract, calling for the acquisition of 23 nursing homes, located in different counties and states, was prepared by an FGL employee—though FGL that year had used several firms of attorneys and had been billed \$110,000 in legal fees [E227, E230, E232]. Firestone, at the trial, in response to a leading question, claimed he had “legal assistance” but could not say whether it was Milbank, Tweed in New York or Pacht Ross in Los Angeles [788a]; and he had no “affirmative recollection” that Milbank Tweed supervised the execution of the Agreement [810a]. And if FGL did not require counsel, what of Monterey—why was it willing to “sell” its assets without the protection of counsel?

Lipkin was a lawyer, with one year's experience in which he acted “concurrently as both an attorney and a CPA” in Chicago [906a, 955a]; he relied on his legal training in determining that the Agreement was valid [918a, 931a]—but he never noticed the missing Exhibits nor wondered why counsel had not been employed. It was this contract, not entered on the books, prepared on a printed form by an employee, under which FGL had paid \$5,000, which was characterized by Laventhol in its audit statement as a transaction by which FGL had “acquired by contract of sale a group of convalescent hospitals”, which “were leased back to the former owners” [E37].

***The "Sale" on the Same Printed Form
to Continental Recreation, Inc.***

Continental Recreation, Inc. ("Continental") apparently had no greater need for lawyers than Monterey or FGL. The contract, under which FGL "sold" the nursing homes to Continental, was prepared by the same employee on the same printed form; the same Exhibits were missing; and the selling price which was \$11.4 million dollars on November 20, 1969 was \$15.3 million on November 26, 1969 [E144], though Ruderian, the principal of Continental, was a hard negotiator who "was never satisfied with the transaction unless he was sure you were going to lose a little money. He was very hard" [781a].

Surely it was suspicious that these transactions, which resulted in a sale of \$15.3 million dollars and a gross profit of \$2,030,500, were a secret from Wadley, the controller, and Scott, FGL's vice President, a stockholder and one of its three directors [520a, 521a, 567a]. Wadley, who closed the books on November 27, 1969 at the request of Firestone [519a], knew nothing about the Monterey transactions until December 18, 1969—almost a month later—when he received a letter from Schwalb, manager of the audit for Laventhol [908a], enclosing "the journal entries which we generated for the financial statements at November 30" [583a, E422]. How could Laventhol, on the basis of these contracts, prepare journal entries, which reflected as consummated transactions, the purchase of convalescent hospitals on November 22, 1969 for \$13,362,500 and their sale for \$15,393,000 at a "profit on sale" of \$2,030,500? [E115, E116, E120, E126].

***There Were No Corporate Minutes,
No Corporate Resolution, No Closing
Statement and No Other Documents
Relative to the Monterey Transaction***

Lipkin admitted he never saw any corporate minutes relative to the Monterey transactions; nor did he see or

check for a corporate resolution approving either the purchase or sale [608a], though the Laventhol work papers certify that there were minutes approving all major contracts [E111]; he never saw a title search nor did he look at the books of original entry [609a] nor did he see a closing statement [615a]; and he did not discuss with Schwalb the absence of minutes approving the two contracts, one for \$13 million dollars and the other for \$15 million dollars [617a].

Surely, these were danger signals which should have caused Laventhol to wonder whether, in Chazen's language, these transactions were "artificial" or "fictitious"; and even if they were not contrived, whether they were structured to bolster the financial statements and were without economic substance.

***Firestone's Memorandum Concerning
Ruderian to Laventhol—"Handle
Him With Kid Gloves"***

More inculcating even than these suspicious circumstances is Firestone's memorandum to Lipkin dated December 2, 1969 [E142], in which Firestone told Lipkin that Continental, which had contracted to pay \$4,965,250 in cash by January 30, 1970 in addition to \$25,000 payable on January 2, 1970, had "a net worth of over \$100,000", consisting of "miniature golf courses plus other assets"; that the controlling stockholder of Continental was Ruderian whose "pattern of operations is to buy and resell prior to final payment on his sales contracts"—and Lipkin was further cautioned "to handle him with kid gloves" [E142].

What more did Laventhol need to be satisfied that the Monterey transactions were structured to sell stock—let alone suspect that it was. In the context of these transactions, the purchaser was a dummy corporation which might have trouble raising \$25,000, let alone the \$4.9 mil-

lion dollars required—and Ruderian did not close unless he resold first—this additional damning evidence, in the context of the other circumstances which have been referred to, and the fact that the transactions appear fortuitously on the eve of the audit which is designed solely to sell stock, should have caused Laventhol to conclude that these transactions were structured for the purpose and ought not to be recognized except to the extent of the sum paid and the sum received—this was the sole economic reality—there was nothing else to report in the financial statements.

The Hawaiian Investors

Corroborating Firestone's memorandum that Ruderian never purchased before he sold was the testimony given by Lipkin in his pre-trial deposition that Ruderian, when called by Boyer, said that he "had people in Hawaii who were interested in going in with him in this deal" [985a], but he (Lipkin) "knew nothing about these people in Hawaii" [985a]. Laventhol therefore knew that Ruderian's pattern of operations was to resell before he bought; and that he was hoping to resell to Hawaiian investors. Clearly, when these contracts were signed, these transactions were at most gleams in the eyes of two real estate operators, Firestone and Ruderian—they did not warrant significant recognition in the financial statements.

Laventhol "Verifies" the Transactions With an Attorney Over the Telephone

Chazen, as "the last word on accounting and auditing . . . for the entire national firm" [836a], decided he needed the assistance of "someone more experienced in real estate matters", and spoke to one of his partners, a Mr. Zeman, who suggested they "call an attorney" [846a].

Neither Chazen, Lipkin nor Zeman considered it necessary to exhibit the contracts to counsel—they were content

to telephone "an attorney Julius Borah" [846a] though his office was minutes away by taxi [885a].

Chazen's telephone conversation with Borah was ludicrous—he said he described the contract to him and inquired "whether this transaction which transferred these interests in real estate was legally enforceable" [849a]. Asked by counsel whether he "described in detail the contents of the contracts", he missed the cue—he replied, "I don't know what you mean by detail"—the best Chazen could do was to speculate that "the description of the contract may have even come more from Mr. Lipkin than me" [848a]. Prompted by the Court to state "what you said and what he said" [849a], Chazen could only add that the contract "provided for the sale of interests in real estate, that there was no recourse to the buyer . . . I told him what the amounts involved were . . . and I asked him whether this contract was legally enforceable within its terms" [849a]. Borah replied that the contract "was a legally enforceable document in his opinion" [849a]. The Court's acerbic comment on the worthlessness of this "legal opinion" was to inquire whether "Borah [had] been joined in this case?" [850a].

In response to further inquiries by the Court, Chazen acknowledged he never asked nor did Borah say that FGL had acquired the property; nor had he asked Borah whether title had passed because he "knew title hadn't passed" [881a]. Chazen, despite his responsibility for making the decision, never looked at the contract with Continental nor could he recall whether he had it in front of him when he spoke to Borah [885a].

Lipkin, whose testimony followed Chazen's, tried without success to bolster Chazen's account of the Borah conversation. He testified that "either he or Chazen listed the exact details of the transaction, relative to the terms of the payment; he also told Borah that the contracts had been signed, that they "appeared to be for California property" (the

contract contradicts this); that the properties consisted of nursing homes and there was a provision for liquidated damages [925a-928a]. He admitted he did not read the contracts to Borah [929a-930a]—he gave Borah the parts he selected which were “a complete recital of the transactions”; in his own legal opinion, the contracts were valid and enforceable and his opinion was confirmed by Borah [930a, 931a]. No further comment is required.

Though at the trial, Chazen admitted that he considered Borah’s legal opinion an “important ingredient” [873a] in determining the treatment to be given the Monterey transaction, Laventhol’s present posture is understandably somewhat different—the telephone call to Borah “was not to solicit a ‘legal opinion’ but to verify the judgments of Laventhol audit partners who were qualified by training and experience to form a conclusion concerning the effectiveness of the contracts” (Laventhol Br., p. 47). It is not inappropriate to observe that counsel’s easy assumption that accountants are qualified to pass judgment on the enforceability of contracts, particularly where such doctrines as “equitable conversion” * are claimed to be involved, is consistent with the preparation of the contracts in the first instance by an FGL employee under Firestone’s supervision.

***Laventhol’s Telephone Call to Ruderian
to “Verify” the Transaction***

Eli Boyer, describing himself as a Laventhol “back-up partner”, came from California to testify that in November or early December, 1969, Lipkin asked him whether he knew Max Ruderian and whether he could find out whether “the transaction that was under discussion was in fact the transaction, and that their part in connection with it was

* This doctrine, which holds that for certain purposes, real estate, subject to a contract of sale, is deemed personalty (19 N.Y. Jur., Equitable Conversion, §1), has not the remotest application here.

real and that they were parties to the transaction" [820a]. Boyer knew Ruderian as a syndicator and as a contributor to charity [823a].

Boyer told Ruderian that the Laventhol firm were the accountants for the Firestone Group and asked "whether he was in fact involved in a possible purchase of a group of nursing homes". Ruderian said "they had a deal with the Firestone Group" [825a]; they had the financial backing they needed to conclude the transaction [825a]; he considered the contract binding and intended to go forward with it [828a]. No writing was obtained from Continental or Ruderian confirming that Continental had a legally enforceable obligation to pay \$5,015,250 to FGL—and of course it could not have discharged any such obligation.

Accordingly, the Ruderian conversation was not even an oral verification—Ruderian hoped to resell the property to Hawaiian investors; and Firestone had expressly advised Laventhol that Ruderian did not purchase until he resold. The conversation with Ruderian therefore amounts to nothing more than glib assurances by a real estate operator that he hoped to go through with a pending deal—so does every other real estate operator.

Laventhol Yields to Firestone's Threats

Upon the trial and in its Brief, Laventhol claims that it consistently maintained that the Monterey transactions were properly included in purchases and sales; that \$235,000 of the profit was includible in net income; and that the balance of \$1,795,500 constituted deferred income. But the Laventhol work papers contradict any such consistency—in fact, there were several flip-flops. First, it was decided to include the entire profit of \$2,030,500; then it was considered that the transaction should not be recorded at all; next, the decision was to report \$235,000 as net income, with the balance of \$1,795,500 to be treated as "unrealized income"; and when this produced threats by

Firestone, the decision to label the "unrealized" income as "deferred" was reached, which as will be shown, furnished Firestone with the tool he needed to consummate the private placement.

***Initial Journal Entries Record
"Profit on Sale" of \$2,030,500***

Initially, a complete set of journal entries were prepared which recorded the entire \$2,030,500 as profit [Pl. Exhs. 14, 15, 16; E115, 116, 126, 130].

A Laventhol work paper, dated December 1, 1969, entitled "Purchase and Sale of Monterey Nursing Homes, Inc. Hospitals", summarizes in detail the purchase and sale transaction, concluding with \$2,030,500 as the "profit on sale" [Exh. 15]. A journal entry was made [Exh. 14] "to record purchase and sale of various hospitals from Monterey to Continental"; and which enters \$2,030,500 as "profit on sale". This journal entry contains a notation "W-1A" which ties in with Exhibit 15, the summary sheet, which similarly contains the notation W-1A. This journal entry was then embodied in the adjusted trial balance [Exh. 16], which also includes in gross profit, the sum of \$2,030,500, with a reference to the notation W-1A.

There is, therefore, a complete set of Laventhol work papers [E115, 116, 126, 130] reflecting the inclusion of \$2,030,500 in gross profit.

***Loss of \$772,108 Before
"Sale" to Continental***

Laventhol's initial determination is corroborated by another work paper which also demonstrates that Laventhol was, of course, fully aware of the critical importance of including the Monterey transactions in sales and profits. This work paper states [Pl. Ex. 23; E155]:

"Loss before sale to Continental Recreation	772,108
Profit on sale to Continental Recreation	2,030,000
Profit before income taxes	1,257,892"

Without the profit on the Monterey transaction, the private placement could not go forward. The unaudited projections by FGL would certainly not be confirmed by a "Loss" of \$772,108. No amount of glib explanations by Firestone could bridge that gap.

Decision to Omit the Monterey Transactions in Their Entirety

Laventhol then decided not to record the transaction "as sale" because "not enough deposit was given Firestone". A work paper entitled "Reclassification Journal Entries", dated December 6, 1969, states [E420]:

"Reverse entry for tax liability for sale to Continental Recreation as LKH&H will not record as sale since not enough deposit was given Firestone."

Laventhol labors to explain that "LKH&H will not record as sale since not enough deposit was given Firestone" was prepared by an "unidentified person" and was "not intended to be taken literally" (Br., p. 56). The work paper, however, appears to bear the initials of Schwalb, the audit manager, and the statement clearly records Schwalb's opinion that the sale could not be recorded because the deposit was insufficient—which it certainly was.

First "Superseded" Laventhol Report—Monterey Profit Described as "Unrealized"

Laventhol, having initially prepared journal entries which included the entire profit of \$2,030,500 in current income, obviously thought better of it, and decided to compromise—accordingly, "Additional Adjusting Entries" [E139] were prepared which recorded the gross profit of \$2,030,500, but recognized \$235,000 as current income and the balance of \$1,795,500 as deferred gross profit.

But Laventhol was not yet prepared to go the whole way with Firestone—though the journal entries described

the \$1,795,500 as "deferred gross profit", a Report was completed, printed and delivered to FGL, which labeled the \$1,795,500 profit, not as "deferred", but as "unrealized gross profit", both on the balance sheet [E390], the Income Statement [E391] and in Note 4 [E393].

Had this Report gone out, it would have destroyed the private placement. There was no way in which "unrealized" income could be added to "deferred income" to demonstrate the profitability of FGL as exceeding that projected in the unaudited statement (*infra*, pp. 23-24); and the disclosures in this Note 4, later wholly rewritten, made clear that the Monterey transactions because of their "nature and circumstances" could not be regarded as consummated. But this report by Laventhol apparently unleashed a furor in the Firestone camp. It was during this period that Alan Scharf, investment advisor to FGL, threatened Laventhol "with loss of the account as well as the possibility of a law suit if the borrowing did not go through" [942a]. The Report was therefore promptly "pulled back".

***Get the Report Back or There Will Be
Hell to Pay—Don't Use the Mails***

The pullback of this "unrealized" profit Report was dramatic. Wadley, the FGL controller, said that a day or two after he received the first Report from Laventhol, Schwalb ordered him to [530a]:

"[G]et all copies of this report back to me at once. There will be hell to pay if we don't get them back, and don't send them by mail, send them by messenger." [530a]

By that time, one of the copies had already been delivered to the City National Bank; and Wadley was unable to get the copy back until he received the revised report and could persuade the bank officer to accept the later report in exchange for the superseded report, which "is the copy in question here" [530a].

Chazen surprisingly claims he never knew there were two Laventhol reports [842a]; he knew nothing about the superseded report until it was called to his attention by counsel [843a]. It seems strange indeed that a Report could be finalized and delivered to the client, then superseded, and a radically different report prepared behind Chazen's back. This mystery remains unexplained if Chazen's testimony is accepted.

But Chazen's testimony, in the light of another major change made in the second Report, casts significant doubt on Chazen's claim.

The initial "superseded" Report was unqualified—the revised Report was qualified by the phrase "subject to collectibility of the balance receivable on the contract of sale" [E32]. Chazen testified he told Lipkin the qualification was necessary "because of the thin equity the buyer had" and because "there was no recourse to the buyer" and added, "and Mr. Lipkin under my concept agreed and *made the change*" [844a].

The critical phrase here is Lipkin "made the change"—the change Chazen described was from an unqualified to a qualified opinion—it follows that Chazen ordered the change, deliberately substituting the label "deferred" for "unrealized", and salved his conscience by qualifying the Laventhol opinion.

***Significant Differences Between Note 4
in the First and Second Reports Were
Further Concessions to Firestone***

(a) In the first Report, Note 4 states that "The company sold by land contract a group of convalescent hospitals which it had purchased *earlier in the month*" [E393]. The proximity in time between purchase and sale, which might arouse suspicion, is omitted in the second Report which states the Company had acquired the hospitals, without mentioning any date.

(b) The first Note 4 does not refer to the leaseback—the second states the properties “were leased back to the former owners” [E37]. Clearly, this leaseback tended to add substance to the transaction.

(c) But devastating proof of the conscious attempt made by Laventhol, yielding to Firestone’s pressure, to dilute disclosures made in Note 4 in the first Report which could destroy the private placement is shown by a side-by-side comparison of comparable sections of Note 4 in the two Reports:

First Report

“Because of the circumstances and nature of the transaction, \$1,795,500 of the gross profit thereon will be considered realized when the January 30, 1970 payment is received. This amount represents the excess of the gross profit resulting from the transaction over the total of the liquidated damages and the two \$25,000 cash payments. *The unrealized gross profit is shown as a reduction of this related receivable in the consolidated balance sheet.*” [E393] (Italics added)

Second Report

“Of the total gross profit of \$2,030,500, \$235,000 is included in the Consolidated Income Statement and the balance, \$1,795,500 will be considered realized when the January 30, 1970 payment is received. *The latter amount is included in deferred income in the consolidated balance sheet.*” [E37] (Italics added)

It is obvious that these changes were the result of agonizing soul-searching on the part of Laventhol, influenced by the powerful pressures exerted by Firestone and Scharf. The elimination in the final report of any reference to “the circumstances and nature of the transaction”; and of the manner in which the \$1,795,500 had been computed,

which pointed up that the \$235,000 included in the income was made up of the liquidated damages and the two \$25,000 cash payments; and the addition of the comment that \$1,795,500 had been "included in deferred income in the consolidated balance sheet", all combine to demonstrate what actually occurred. Firestone desperately needed the "deferred income" label to consummate the private placement and Laventhol submitted.

The "Deferred" Profit Label Had Its Intended Effect on Herzfeld

Herzfeld testified that the word "deferred" meant "that this is a profit that the company had made and was going to pick up in a subsequent accounting period" [354a, 355a]—This is the dictionary definition—Webster defines "deferred income" as "income received but not yet earned" (3rd New Int'l Dict.) p. 591.

Webster's definition is elementary accounting. The standard textbook illustration of deferred income is "rent received in advance" (Horwath & Toth, *Hotel Accounting* [Rev. Ed. 1948, p. 267]; see, Kester, *Advanced Accounting* [1946] p. 387; Stettler, *Auditing Principles*, Prentice Hall, Inc. [1956], p. 403).

"Unrealized" and "deferred" income are at opposite ends of the revenue recognition spectrum. Unrealized income has not been received—and the transaction has not arrived at the point where the earning process is complete or substantially complete and an exchange has taken place (*A.I.C.P.A., A.P.B.*, Statement No. 4, §150). Deferred income on the other hand is money in hand which has not yet been earned—as for example, the prepaid interest and management fees included in the FGL statement—these were sums paid in advance to cover interest and management fees which would be earned in the future [Note 7, E38].

***Firestone's Effective Use of the
"Deferred Profit" Report***

Firestone made skillful use of the deferred profit reported by Laventhol. In forwarding the Laventhol report to the investors by letter dated December 16, 1969 [E28], he stated:

"One transaction which is reflected in the November 30 audited financial statements has been treated as producing deferred gross profit rather than current gross profit. While the combination of current and deferred income is actually higher than projected (\$1,411,557 as compared with \$1,360,000 projected), the shift of \$1,795,500 of gross profit on this transaction from a current basis to a deferred basis by the auditors has reduced current net income below that originally projected".

Firestone was able also to make this dramatic statement:

"Deferred income shown on the audited balance sheet has been increased to \$2,834,133 as against \$1,421,000 projected. A breakdown of the components of the deferred income account is shown in the audited financial statements."

Clearly, Laventhol's switch from "unrealized" to "deferred" gave Firestone the tool he needed to flim-flam the investors by telling them that under the Laventhol audit report, the FGL deferred profit was greater even than projected. What better way is there to instill confidence in investors than by telling them that independent auditors had confirmed that actual deferred profit exceeded management's projection. Laventhol had deliberately furnished Firestone with an accountant's certificate which, in this case, was the instrument "for inflicting pecuniary loss more potent than the chisel or the crowbar" (*U.S. v. Benjamin*, 328 F. 2d 854, 863 [2d Cir. 1964]).

***The Deferred Profit Page
of the Laventhol Report***

The Report as finally distributed to Allen and to the investors contained a separate page entitled "Schedule of Deferred Income", which is critically probative as to the significance of "deferred income". This page, headed "SCHEDULE OF DEFERRED INCOME", reads:

Deferred gross profit (Note 4)	\$1,795,500
Prepaid interest (Note 7)	749,397
Prepaid management fee (Note 7)	289,236
	<hr/>
	\$2,834,133"

Chazen said he never saw this schedule of deferred income "in any report that I recall" [868a-869a] and the claim apparently is that this page was added to the report by Firestone, unbeknownst to Laventhol. Though Laventhol called Firestone as a witness, he was not asked about this and never acknowledged that he had added an unauthorized page to the Laventhol report.

But whether authorized or not, this Schedule merely utilized the deferred income figures furnished by Laventhol in its Report—and, of course, Firestone, by placing the items of *prepaid* interest and *prepaid* management fees in juxtaposition to the gross profit on the Monterey transaction, served to enhance the impression that the Monterey profit was assured, which, of course, it was not—but it was the Laventhol report which permitted this.

Right of Rescission Offered Herzfeld

The FGL letter [E28], dated December 16, 1969, which could correctly state in the light of the Laventhol report, that deferred income shown on the audited balance sheet had been increased to \$2.8 million dollars from \$1.4 million projected [E29], also advised the investors that if the changes reflected in the audited statement would re-

sult in a change of their investment decision, their subscription payment would be promptly refunded, adding that Allen had assured FGL that it would replace any cancelled subscriptions [E30].

With profits twice those projected and a major investment banking firm satisfied to replace any cancelled subscription, Herzfeld did what any investor would do—he did not rescind.

The Illusory Liquidated Damage Clause

Laventhol claims to have been conservative in limiting the recognition of income to \$235,000, of which \$25,000 was the initial deposit, another payment of \$25,000 was due on January 2, 1970, and \$185,000 was a sum equal to the provision for liquidated damages “in the event of failure to comply” [Pl. Exh. 21; E145]. The obvious question is “failure to comply”—with what? If Continental did not exercise its right to pay \$4,990,250.00 to obtain title, was this a failure to comply?

It is not surprising that when Continental failed to close on January 30, 1970, FGL made no effort to collect liquidated damages—instead, as the 1970 Annual Report to Shareholders, states [Pl. Exh. 9; E45]: “The buyer requested an extension to July 1”; the extension was granted “with the understanding” that FGL had the right to sell the property “to a third party”; and that, “as a backstop, we have been proceeding to do just that, and expect to be able to obtain at least the same price elsewhere” [E45].

While Laventhol, of course, could not have anticipated the cavalier manner in which FGL would treat this supposedly binding obligation of Continental, the collapse of the Continental transaction points up the burden which rested on Laventhol to obtain a proper written legal opinion as to the enforceability of the obligation of Continen-

tal to pay \$4,990,250.00, and of the liquidated damages clause.

Though Laventhol in its brief states that "the Monterey transactions fell through" many months thereafter, the record discloses [E403] that on January 23, 1970, Ruderman had written Firestone regarding its failure to submit title papers, a copy of the C.C.&R.'s (Covenants, Conditions and Restrictions) and a copy of the lease, which rendered impossible performance of the agreement by the "dates called for". The Monterey deal therefore was off before January 30, 1970.

FGL Files Under Chapter XI

FGL filed a petition under Chapter XI of the Bankruptcy Act in 1971 [597a], and Herzfeld surrendered his securities under the Plan of Arrangement [E174] in exchange for a 10% payment which was included in arriving at the \$357,000 deemed to have been paid by Allen, leaving damages of \$153,000 [1117a, 1118a, 1130a].

There Was No "Thoughtless Slip or Blunder"

The evidence which has been reviewed in the foregoing, culminating in the "pullback" of the superseded report, demonstrates that the deficiencies in the Laventhol report were not a "thoughtless slip or blunder" (cf. *Ultramares, infra*, p. 179). The Report, as finally submitted, was the result of deliberate election by the Laventhol partners—between a realization that the Monterey transactions should be excluded in their entirety—and the certain knowledge that if these transactions were omitted, the private placement could not be closed, FGL might go under, the account would be lost, and Laventhol would be confronted by the lawsuit which Alan Scharf, the FGL investment advisor, had threatened [942a].

Impaled thus on the horns of a dilemma, torn between the prospect of a lawsuit by investors and the threatened

lawsuit by FGL, Laventhol opted for the lawsuit now before the Court.

Upon the whole record, Laventhol's liability to plaintiff, under the authorities, is inescapable.

POINT I

**The Laventhol Report Was False and Misleading—
It Contained Numerous Misrepresentations and Failed
to Disclose Material Facts Relative to the Monterey
Transactions.**

False Representations in the Income Statement

The Statement of Income in the Laventhol report was critically false in the following respects:

1) The Statement of "Sales \$22,132,607" falsely included \$15,393,000 as the sales proceeds of the Monterey Nursing Homes though title had not passed and no sale was made.

2) The Statement of "Cost of Sales \$19,814,920" falsely included \$13,362,500 as the cost of the purchase by FGL of the Monterey Nursing Homes though FGL never acquired title and the purchase was not made.

3) Gross Profit on Sales was stated to be \$2,317,687 which falsely included \$2,030,500 as the profit on the sale of the Monterey Nursing Homes though they were neither purchased nor sold.

4) Deferred Gross Profit was stated at \$1,795,500 though there was no such "deferred" profit.

5) Gross Profit on Sales was stated at \$522,187 which falsely included \$235,000 as the profit attributable to the Monterey transactions.

6) Total Income was stated at \$981,579 which falsely included \$235,000 as the realized profit on the Monterey transactions.

7) Income before Income Taxes was stated at \$104,479 when it should have shown a loss of \$130,521 by excluding the profit on the Monterey transactions.

8) Net Income, shown at \$66,916, should have reflected a loss of \$169,000.

9) Retained Earnings stated at \$66,916 should have reflected a deficit of \$102,084.

10) Earnings Per Share stated at 10 cents per share should have reflected a loss of 25 cents per share.

***False Statements in the
Balance Sheet***

The Balance Sheet in the Laventhol Report was false in the following respects:

1) The Assets falsely included \$4,990,250 as the "Balance Receivable on Contract of Sale", though the receivable depended upon the speculative possibility that the Monterey transaction might close.

2) Current Assets, stated at \$6,290,987 falsely included the \$4,990,250 as a current asset.

3) Total Assets, stated at \$15,218,068 falsely included \$4,990,250 as a Current Asset and \$1,015,250 as a long-term receivable, overstating the Assets by \$6,005,500.

4) Deferred Income stated at \$2,834,133 falsely included \$1,795,500 attributable to the Monterey transactions.

5) Shareholders' Equity, stated to be \$684,084, should have reflected a deficit of \$1,221,416 resulting from the elimination of the Profit attributable to the Monterey transactions after credit for the \$25,000 payment made.

Note 4 Was Misleading

Note 4 makes the following misstatements of material facts and omits other relevant facts as follows:

(a) The Note falsely certifies that FGL "acquired by contract of sale" a group of convalescent hospitals. FGL acquired nothing by its \$5,000 deposit.

(b) The Note states that the property was leased back to its former owner. This is false because there was no lease.

(c) The Note certifies that in November, 1969, FGL "sold the properties by means of a contract of sale". The properties were not sold—FGL could not sell property it did not own and never acquired—and Continental did not acquire a \$15.4 million dollar property with a \$25,000 deposit.

(d) Note 4 misstates the provision for liquidated damages—it states that the sales agreement provides for liquidated damages of \$185,000 if the buyer "fails to perform". The contract [Pl. Exh. 21; E145] provides for liquidated damages if the buyer fails to "comply".

(e) Note 4 omits to state that Continental had a net worth of \$100,000, principally in non-liquid assets, and that Continental would not consummate the purchase unless it had first resold the property to outside investors.

(f) The Note omits to specify that under the contracts, FGL "reserved the right" to purchase the property from Monterey and that Continental similarly reserved the right to purchase the property from FGL.

(g) Note 4 states that \$235,000 is included in income—it omits to state that this "realized" profit consisted of the two \$25,000 payments, only one of which had been received, and the \$185,000 in liquidated damages, which would be payable, if at all, only if the sale was not consummated.

The skeletal description of the bare bones of the transactions contained in Note 4 disclosed none of these material facts to the investors. Yet, it is fair to say that the linchpin of Laventhol's case is the qualified certificate and its reference to Note 4.

It was this qualification and Note which, according to Laventhol, would have disclosed to Herzfeld that the "realization" of income from the Monterey transactions "was so uncertain in the minds of the accountants that they qualified their opinion" (Br., pp. 18-19).

But the qualification [E32] "subject to the collectibility of the balance receivable on the contract of sale [see Note 4]", is itself deceptive. The phrase "balance receivable" does not appear in Note 4. *Non constat* that these words did not refer to the sum of \$1,015,250, which is described as the "note secured by trust deed". Indeed, Note 4 describes the sum of \$4,965,250, not as a "balance receivable", but as "Cash"—does not this mean that cash had been deposited in escrow pending the closing or had otherwise been committed? The classification of the profit as "deferred" rather than "unrealized" would signify to sophisticated investors and even accountants that the cash payment was assured.

In this context, Laventhol (Br., pp. 33-35) misplaces its reliance upon *S.A.P.* 33, which governs the rendition of qualified opinions and which is explicit that the qualification "should give a *clear explanation* of the reasons for the qualification and of the effect on financial position and results of operations, if reasonably determinable". [p. 58]

It is at this point that Laventhol's case collapses. Laventhol admits (Br., p. 8) that the reason Laventhol qualified its opinion was because Continental had to pay \$4,990,000 before January 30, 1970, though its "net worth was \$100,000".

Why then did Laventhol fail to disclose in Note 4, as S.A.P. 33 required, the basic reason for the qualification, i.e., "Continental's net worth was \$100,000"? The only inference which can be drawn from this is that Laventhol deliberately chose to prepare a Note which would purport to explain its qualification, but would not in fact do so.

As Judge Friendly pointed out in *U.S. v. Simon*, 425 F. 2d 796 (2d Cir. 1969), in reviewing the footnote there involved, "the jury could reasonably have wondered how accountants who were really seeking to tell the truth could have constructed a footnote so well designed to conceal the shocking facts" (p. 807). At best, what Laventhol did here was "calculated to communicate as little of the essential information as possible while exuding an air of total candor" (*Feit v. Leasco*, 332 F. Supp. 544 [EDNY 1971]). (p. 565)

***Laventhol Should Have Disclaimed
Any Opinion Under S.A.P. 33***

But Laventhol not only failed to comply with S.A.P. 33 by its omission of any "clear explanation" of the reasons for its qualified opinion, it violated S.A.P. 33 in rendering even a qualified opinion, accepting its own reason for the qualification. S.A.P. 33 (Ch. 10, p. 58) states:

"When a qualification is so material as to negative an expression of opinion as to the fairness of the financial statements as a whole, either a disclaimer of opinion or an adverse opinion is required."

And further (S.A.P. 33, pp. 59-60):

"The necessity of disclaiming an opinion may arise . . . from the existence of unusual uncertainties concerning the amount of an item, or . . . the outcome of a matter materially affecting financial position or results of operations . . ."

How more "unusual" can "uncertainties" be than the uncertainty of the payment of \$4.9 million dollars by a company with a net worth of \$100,000, and is it possible to conceive of a transaction more material than one which involves almost 70% of sales; where its recognition is necessary to show a profit; and where the audit report is prepared to sell securities.

S.A.P. 33 Violated by Laventhol's Failure to Secure "Competent Evidential Matter" of Its Verifications of the Monterey Transaction

S.A.P. 33 requires (Ch. 2, p. 16):

"Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination".

As to confirmation of receivables, it is provided:

"Confirmation of receivables requires direct communication with debtors; the method and time of requesting such confirmations . . . are determined by the auditor" (p. 38).

The "materiality of the amounts involved" is a factor to be considered by the auditor in selecting the method, "extent, and timing of his confirmation procedures" (p. 38).

We need hardly add that the confirmation of a \$5 million dollar receivable, attributable to a \$15.3 million dollar sale out of total sales of \$22.1 million, required not a telephone call but the most rigorous and detailed confirmation and the obtaining of competent evidential matter upon which reliance could reasonably be placed. For the same reason, Laventhol could not accept a legal opinion obtained over the telephone of which it had no record.

Neither telephone call had any value and proves once more that Laventhol failed flagrantly to adhere to the minimum auditing standards provided for in S.A.P. 33.

***The Laventhol Misrepresentations
Were Like Standing Dominoes***

The misrepresentations in this case are comparable to those described in *Fischer v. Kletz*, 41 F.R.D. 377, 381 (SDNY 1966), quoted in *Green v. Wolf Corp.*, 406 F. 2d 291, 300 (2d Cir. 1968):

"Like standing dominoes . . . one misrepresentation in a financial statement can cause subsequent statements to fall into inaccuracy and distortion . . ."

The critical misrepresentation here was the inclusion in sales of the \$15.3 million dollar Monterey transaction [E34]. This figure, which was not footnoted, was wholly false—and like the standing dominoes in *Fischer v. Kletz*, *supra*, resulted in distorting every other figure in the income statement. Once Laventhol decided to include in gross sales the \$15,393,000 "selling price" of the Monterey hospitals, the dye had been cast—there was no way out for Laventhol to present a true financial picture of FGL.

If the sale were included, the cost of sales had to be recorded and the gross profit of \$2,030,500 had to be taken into account. Then it became necessary to deal with this fictitious profit—obviously it could not be deemed to have been realized on the basis of a \$5,000 deposit by Firestone and a \$25,000 deposit by Continental Recreation.

From this point on, the road was tortuous, as has already been shown, involving a series of flip-flops, a "super-seded" report and the final report which furnished Firestone with the "chisel and crowbar" he needed to "burglarize" the FGL investors. When Laventhol switched the label on the Monterey "profits" from "unrealized" to "deferred", Firestone could glibly assert that "deferred in-

come shown on the audited balance sheet has been increased to \$2,834,133 as against \$1,421,000 projected" [E29]; and the placement was assured.

***The Treatment of the Monterey Transactions
Was Not Consistent with GAAP***

Laventhol states, we submit incorrectly, that the Court below concluded that "the treatment of the [Monterey] transactions" was "not inconsistent with generally accepted accounting principles" (Br., p. 28). Actually, the Court never reached that question, rendering its decision upon the fundamental issue whether the financial statements fairly presented the financial condition of the company [192a].

Laventhol urges that this is a "novel doctrinal point" (Br., p. 29)—we submit that it is not, but before addressing ourselves to this question, it will be shown that the treatment by Laventhol of the Monterey transactions was in plain violation of every applicable accounting principle.

Plaintiff produced expert accounting evidence that under generally accepted accounting principles, neither a purchase nor a sale may be recorded until title has passed [366a-367a].

Chazen, Laventhol's expert, did not disagree with this principle. He testified [852a] that the Monterey transactions were properly included because they were "completed", the property was "purchased" and "sold" and FGL "had performed . . . substantially all of the services required under the agreement so that the earning process was virtually complete" [852a]. And this undisputed principle is confirmed by the rules promulgated by the American Institute of Certified Public Accountants (*supra*, p. 22), which state that revenue is recognized when "the earning process is complete or virtually complete", and "an exchange has taken place".

Laventhol claims that there are exceptional circumstances under which a transaction may be recorded in sales though title has not passed and refers to "long-term leases with options to purchase at the end"; and "conditional sales with title reserved in the seller for security purposes" (Br. p. 40).

Laventhol blinds itself to the difference between the Monterey transactions and the illustrations mentioned, where the lessee or purchaser has taken possession of the property and the underlying economic reality is that a consummated transaction has taken place, with title reserved for security purposes.

This is not the case here—there was no long-term lease, no conditional sale; there was a \$5,000 payment in respect of a \$13.2 million dollar purchase and a \$25,000 deposit under a \$15.3 million dollar contract—the economic reality of the transaction adds up to nothing.

In fact, accepted accounting principles look the other way—revenue is not recognized even though title has in fact passed, where the seller retains effective control, there is a small down payment and there is uncertainty as to the realization of the profits of the sale (C.C.H. Fed. Sec. L. Rep. ASR-95, ¶72,117, Dec. 28, 1962).

Thus, in a series of cases, the Commission held in ASR-95 that though title had passed, the "circumstances" rendered it "inappropriate to recognize gross profit as recorded as having been realized at the time of sale". The "circumstances" applicable here, which were referred to by the Commission as precluding the recognition of income included, *inter alia*:

"1. Evidence of financial weakness of the purchaser.

* * *

3. Substantial uncertainty as to amount of proceeds to be realized because of form of consideration . . . e.g. non-recourse notes . . . of indeterminate value.

4. Retention of effective control of the property by the seller.

* * *

8. Small or no down payment."

These considerations merely follow basic canons of accrual accounting theory. As the Commission's Chief Accountant observed (C.C.H. Fed. Sec. L. Rep. [72-73 Transfer Binder] ¶79,094, p. 82,368), its views on the proper treatment of land sales followed the "basic canons of accrual accounting theory" which "require revenue to be recognized when the essential ingredients of the earning process are complete".

To suggest that the earning process was substantially complete here borders on the absurd. All that FGL had done was pay \$5,000 under its contract and accept a \$25,000 deposit from Continental. Many things remained to be done by FGL, which it never did, including, *inter alia*, the consummation of its purchase from Monterey by paying \$3.9 million dollars, the furnishing to Continental of current title reports, the delivery of the CC&R's and of a copy of the lease (which apparently never existed) [E403]. Applicable here is the comment that "to say that the earning process has been completed at this point requires imagination indeed" *supra*, p. 82,368.

The S.E.C. has repeatedly reasserted the view expressed in ASR-95, which Laventhol admitted it was aware of when its Report was rendered (989a). Thus, in *Great Southwest Corp.*, C.C.H. Fed. Sec. L. Rep. (72-73 Transfer Binder) ¶79,194, the Commission ruled that even though real estate transaction met the formal legal requirements of sales, their recognition as sales for accounting purposes was "materially misleading" because there was not "a sufficient exchange or conversion, in economic terms, with respect to the seller's interest in the property to justify treating the transaction for financial reporting purposes

as a sale on which profit may be recognized" (p. 82,625); and in *Major Realty Corp.*, C.C.H. Fed. Sec. L. Rep. (70-71 Transfer Binder) ¶78,027, the Commission similarly determined that a real estate sale had not been consummated because the down payment was less than 1% of the purchase price; the buyer "had assets of only a nominal amount"; and the note given to seller "was a nonrecourse note". The Commission ruled, "the transaction must be accounted for in a manner which follows its substance rather than its legal form" (p. 80,251).

Here, Laventhol's treatment of the Monterey transactions followed neither their substance nor their form—title had not passed; the original owner remained in possession; and the only economic events that had occurred were the payments of \$5,000 by FGL and \$25,000 by Continental. These minimum payments do not even "structure" a consummated purchase and sale.

The Commission has recently condemned the practice of structuring real estate transactions in an attempt to comply with ASR-95 (C.C.H. Fed. Sec. L. Rep., ASR No. 173, July 2, 1975, ¶72,195):

"In the Commission's opinion these three real estate transactions were structured by GSC with the concurrence of Penn Central's management in an unsuccessful attempt to meet the criteria contained in ASR-95. . . . PMM should have recognized the attempts by management to structure transactions in a contrived manner to meet the technical criteria of existing accounting literature, when in the Commission's view, they did not" (pp. 62,472-473).

In the transactions considered, substantial cash payments had been made, amounting to \$6 million dollars in one transaction, \$2.9 million in another and \$5.4 million in a third, yet the Commission held that revenue should not have been recognized.

In the same Release, the Commission dealt with revenue recognition on real estate transactions where there is no assurance that requisite financing is available, and held, on the basis of documentation far more convincing than the telephone calls made by Laventhol, that sufficient evidence of available financing had not been secured (p. 62,476):

"In determining whether there existed a commitment of Federal financing, PMM relied on representations of Stirling Homex management, the Company's supposed experts on government housing programs, an opinion of outside counsel furnished by management, apparent concurrence of other reputable organizations dealing with the Company, and the belief that local housing authorities would not enter into contracts for projects without reasonable assurance that funding would be available. . . ."

By contrast, all that Laventhol had here was Ruderian's oral assurance that he had the "financial backing" he needed [825a].

***Laventhol's Report Was False and
Misleading Under Rule 10b-5***

Even if one were to swallow Laventhol's contention that "deferred profit" is somehow equivalent to "unrealized profit" (though the pullback of the "superseded report" proves conclusively that Laventhol knew better—otherwise, why the change?), Laventhol would still "run foul of the principle" that one under a duty to speak, is obligated to disclose "such additional matters known to him as he knows to be necessary to prevent his partial statement of the facts from being misleading" (*S.E.C. v. Great American Industries, Inc.*, 407 F. 2d 453, 461 [2d Cir. 1968]). A failure to disclose, under these circumstances, constitutes "common law fraud" and "Rule 10b-5 is plainly applicable" (*S.E.C. v. Great American Industries, supra*, p. 461).

"[A] half truth is as bad as an outright lie" (*Trussell v. United Underwriters, Ltd.*, 228 F. Supp. 757, 762 [D. Colo. 1964]); "[A] statement of a half truth is as much a misrepresentation as if the facts stated were untrue" quoted from *Equitable Life Insurance Co. of Iowa v. Halsey, Stewart & Co.*, 312 U.S. 410, 424, 425; "Two half-truths are equal to one whole lie" (Briloff, "Unaccountable Accounting" [1972], p. 411).

Certainly, the duty imposed upon Laventhol, as an independent auditor, is at least as great as that imposed upon a principal in the transaction, "which precludes not only the conveyance of half truths" but "failure . . . to disclose the full truth" (*List v. Fashion Park, Inc.*, 340 F. 2d 457, 462 [2d Cir. 1965]); and, this "obligation of insiders to inform outsiders of all material facts" is imposed "regardless of the sophistication or naivete of the persons with whom they are dealing" (*List, supra*, p. 463).

Upon analysis, the *Simon* case, *supra*, is practically dispositive of Laventhol's contention that it had no obligation to make the disclosures of facts known to it concerning the Monterey transaction. In *Simon*, as here, the issue revolved around the treatment of a receivable described in a footnote which the defendants contended constituted adequate disclosure. The footnote described the receivable of \$2.1 million dollars as secured by the debtor's equity in "certain marketable securities", which "at current market quotations exceeded the net amount receivable" (425 F. 2d, at p. 800).

The Government contended that the Note should have disclosed additional facts, e.g., that the receivable "was uncollectible" as of a prior date; that 80% of the collateral securities consisted of stock and convertible debentures of Continental Vending; and that subsequent to the closing date, the receivable had grown from \$2.1 million to \$3.9 million dollars, rendering the market value of the collateral less than the amount of the receivable.

Defendants called as witnesses "eight expert independent accountants, an impressive array of leaders of the profession", who testified that the treatment of the receivable, as footnoted, adhered to generally accepted accounting principles and "made all the informative disclosures reasonably necessary for fair presentation of the financial position of Continental . . ."

This Court, holding that the critical test was whether the financial statements fairly presented the financial position of Continental (which the District Court followed in this case), determined in effect that it was the obligation of accountants to disclose certain additional facts, which Laventhol complains constitute "descriptive and evaluative materials" (see App. Br., p. 3), such as that the affiliate was being used by the President of Continental for his private benefit; that "the bulk of the pledged securities was of the one sort most inappropriate to 'secure' the Valley receivable". The Court held that the failure of defendants to make these disclosures, "rather than being a following of accepted accounting principles, was part of a deliberate effort to conceal what defendants knew of the diversion of corporate funds that Roth had perpetrated" (pp. 807-808).

Similarly here, the District Judge had the right to find that Laventhol deliberately concealed what it knew of the relevant facts concerning the Monterey transactions, to wit, that the purchaser had a net worth of \$100,000 invested in miniature golf courses; that FGL did not have title to the hospitals; that it had not conveyed title to Continental; that there was no assurance that the sale would be consummated; that it was the practice of the principal to resell before he bought; and the other facts referred to by the Trial Court.

We submit that here, as in *Simon*, the District Court had a right to find that Laventhol had failed to disclose facts "under circumstances crying for a disclosure" (p.

807), and to wonder "how accountants who were really seeking to tell the truth could have constructed a footnote so well designed to conceal the shocking facts".

What is critical here is the fact that Laventhol "made a studied effort to avoid stating explicitly" the salient facts concerning the Monterey transaction, and that its treatment of the Monterey transaction was "designed to create the false impression" that a purchase and sale had been consummated and that the profit had been realized but was being deferred to a subsequent accounting period—"Thus, fraud was found" (cf. *Kohn v. American Metal Climax, Inc.*, 458 F. 2d 255, 262 [3rd Cir. 1972]).

In dealing with the adequacy of the disclosure, and the contention of Laventhol that sufficient information was included in the report, which should have adequately disclosed to the plaintiff all of the pertinent facts, the cases are clear that while stockholders need not be addressed "as if they were children in kindergarten" (*Richland v. Crandell*, 264 F. Supp. 538, 554 [SDNY 1967], quoted in *Gerstle v. Gamble-Skogmo, Inc.*, 478 F. 2d 1281 [2d Cir. 1973]), still "it is not sufficient that overtones might have been picked up by the sensitive antennae of investment analysts" (p. 1297).

Investors are not analysts and are not trained accountants—they cannot be expected to have the sophistication of accountants in putting together clues and deducing what should have been disclosed in plain language.

As Judge Friendly has pointed out, "accounting concepts are a foreign language to some lawyers in almost all cases, and to almost all lawyers in some cases" (*U.S. v. Kovel*, 296 F. 2d 918, 922 [2d Cir. 1961]). Judge Friendly's observation was quoted in *Burroughs International Co. v. Datronics Engineers, Inc.*, 255 A. 2d 341 (Md. 1969), where the Court, in similar vein, referred to its "involuntary excursion into the *terra incognita* known to accountants as GAAP" (p.

341). And if accounting is a foreign language to lawyers and *terra incognita* to Judges, how much more alien are these esoteric concepts, referred to by the Trial Judge, to investors? Certainly, "the English language has sufficient resources" to have enabled Laventhol fairly to describe the Monterey transaction (*cf. Gerstle*, at p. 1298).

The decision in *Republic Technology Fund, Inc. v. Lionel Corporation*, 483 F. 2d 540 (2d Cir. 1973) is applicable here. There, it was claimed that financial statements were misleading because of the failure, *inter alia*, to write off \$998,000 for the good will of a subsidiary, though a footnote disclosed that the company was producing a device not yet marketed; and stated there was no assurance "whether it will be a profitable item" (p. 546). The Court held that the stockholders "were being shown the frosting on the cake with no allusions in the statements to the fact that a substantial part of the cake itself was dried out, if not mildewed" (pp. 546-547).

We submit that the investors were entitled to a simple statement that Continental, as the purchaser, had a net worth of \$100,000; that the transaction would not be closed unless necessary financing was obtained; and that there could be no assurance that such financing would be available. To report that FGL had realized a "deferred gross profit" of \$1,795,500 on the Monterey transaction was to disclose the "frosting", not the "mildew".

In *Feit v. Leasco*, 332 F. Supp. 544, 549 (EDNY, 1971), the Court said:

"Using a statement to obscure, rather than reveal, in plain English, the critical elements of a proposed business deal cannot be countenanced under the securities regulation acts" (p. 549).

The investor is entitled, the Court added in *Leasco*, to "an honest and open statement, adequately warning of the

possibilities of error and miscalculation and not designed for puffing . . ." (p. 549).

Apt here is Judge Mansfield's observation in *Norte v. Huffines*, 304 F. Supp. 1096 (SDNY 1968) that stockholders are not required "to go through a tortuous and difficult process" in order to "figure out" the facts (p. 1106).

The investors here were not required to go through the process of reading the qualification, the balance sheet, the income statement and the fine print in Note 4 to figure out, *if they could*, that there was grave uncertainty in the Monterey transaction—they were entitled to a plain statement that Continental had a net worth of \$100,000 and that the receivable would not be paid unless Ruderian obtained the financing he believed he had.

Laventhol argues mightily that a financial statement is not a prospectus and that the facts which the District Court held Laventhol should have disclosed are appropriate in a prospectus, but have no place in a financial statement. Obviously, no mathematical formula can be designed to predetermine the disclosure required to convey the truth to the investors. It is not necessary to decide whether Laventhol should have disclosed point by point the 10 facts specified in the District Court's decision or could or should have summarized their effect by making clear that the consummation of the transaction was uncertain and that the deferred profit was really unrealized and dependent upon an uncertain event.

What Allen and the investors were entitled to was an honest statement of the facts which would have conveyed, not obscured, the truth. As the minimum, Laventhol should have disclosed that Continental had net worth of \$100,000; that it had not been established by a proper legal opinion that Continental had any enforceable obligation to consummate its purchase; that FGL had not acquired title nor had it conveyed title; and that the con-

summation of the transaction was contingent upon Kuderian's obtaining the necessary financing.

We submit that Laventhol weeps crocodile tears for itself and all other accountants when it complains that GAAP furnishes no blueprint for adequate disclosure which will fairly present the financial condition of a company. It may be that as with respect to scienter, there is no "litmus paper test" for defining the adequacy of disclosures in a financial statement (*Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F. 2d 341, 356, 393 [2d Cir. 1973], Gurfein, J., at p. 393); and perhaps disclosure, like scienter and obscenity, is "something recognized when seen but not otherwise definable" (p. 397).

Here, there was no disclosure, only deception—the facts which caused the qualification of the Report and the "high level of contingency" and the "unusual uncertainties" concerning the consummation of the Monterey transactions, were deliberately withheld. The financial statements prepared by Laventhol were false and deliberately so—the salient facts were withheld "under circumstances crying for full disclosure".

The record overwhelmingly establishes that the Laventhol report was false and misleading.

POINT II

Plaintiff Was Misled by the Laventhol Report Which, in Any Event, Was the "But For" Cause of the Private Placement and Plaintiff's Loss.

It is now well settled that proof of reliance is required only "to certify that the conduct of the defendant actually caused plaintiff's injury" (*List v. Fashion Park Inc.*, 340 F. 2d 457, 462 [2d Cir., 1965]).

"... (R)eliance is established in a Rule 10b-5 action if the 'misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient's] loss.'" [*Chris Craft Industries, Inc. v. Bancor Punta Corp.*, 480 F. 2d 341, 373 (2d Cir., 1973)].

Here, the Laventhol Report was "prepared for the purpose of a private placement by Allen & Co., Inc." [606a]; it was "presented to Allen & Co., Inc. in connection with their participation in the private placement of \$7.5 million dollars of securities of The Firestone Group, Ltd." [607a]; the minutes of a special meeting of the Board of Directors of FGL, held on November 13, 1969, referred to in the Laventhol Report (Note 12), contains a resolution that the corporation "issue and sell the securities through Allen & Co., Inc. to a limited group of private investors" [E353]; and the Laventhol Report states (Note 12) that on November 13, 1969, the FGL Board of Directors "approved an arrangement . . . with Allen & Co., Inc. for the private placement of up to \$7.5 million dollars" of promissory notes and 150,000 shares of common stock to be sold in units of \$250,000 notes and 5,000 shares of common stock for a purchase price of \$255,000 per unit. [E39]

Moreover, as has been shown, the sole function of the Laventhol audit was to "serve as the basis for confirming the unaudited Projected Financial Statements" annexed to

the Purchase Agreement as Exhibit B [E36]. This therefore was not a routine audit which might conceivably be used for a number of purposes. Here, the use of the Laventhol audit in the private placement was the "end and aim of the transaction", not merely "one possibility among many" (*Ultramares Corp. v. Touche*, 255 N.Y. 170, 182 [1931]).

Even if Herzfeld has not seen the Laventhol Report, the "nexus" between the Report and his investment could not be more clearly established. Had Laventhol disclaimed an opinion; had it certified that there was an operating loss; had it stated that Continental had a \$100,000 net worth and there was no assurance that the Monterey transaction would close, Allen could not have gone forward with the private placement, and Herzfeld would not have made any investment.

Since causation in fact is the test, proof of indirect reliance is of course sufficient under Section 10b-5 (*Chrysler Industries, Inc. v. Piper Aircraft Corp.*, *supra*, p. 373. There, where plaintiff's tender offer was adversely affected by defendant's representations made, not to plaintiff, but to the stockholders of the target corporation, it was held that reliance was established—since the "misrepresentation is a substantial factor in determining the course of conduct" which has resulted in the loss; under such circumstances, the "misrepresentation" has been "in fact the cause" of plaintiff's injury.

This is merely an application of the generally established doctrine that "privity between plaintiffs and defendants is not a requisite element of a Rule 10b-5 cause of action for damages" (*Shapiro v. Merrill, Lynch, Pierce, Fenner & Smith*, 495 F. 2d 228, 239 [2d Cir. 1974]). The Court there said (p. 239):

"In short, causation as an element of a Rule 10b-5 cause of action can be established notwithstanding lack of privity".

The Court quoted with approval the observation in *Mitchell v. Texas Gulf Sulphur*, 446 F. 2d 90, 101 (10th Cir. 1971):

"[P]erhaps the first step is to realize that the common law requirement of privity has all but vanished from 10b-5 proceedings while the distinguishable 'connection' element is retained".

The same rule was more recently applied in *Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath*, C.C.H. Fed. Sec. L. Rep. §95,090 (2d Cir. 1975), where the Court again reiterated the doctrine, spelled out in its earlier decisions, that "to the extent that reliance is necessary for the finding of a 10b-5 violation in a non-disclosure case, . . . the test is properly one of tort 'causation in fact'" (p. 97, 865).

Herzfeld therefore would have a clear right to recover even if he never saw the Laventhol Report. He had been told by FGL [E5] that the closing would not take place until an audited financial statement had been submitted which would confirm the unaudited financials; and he had a right to believe that Allen would not proceed in the absence of a satisfactory audited report.

There was therefore clearly established the necessary "connection" between the misleading Laventhol report and Herzfeld's loss. Herzfeld, offered the right to rescind, was advised that Allen intended to go forward with the private placement and would "replace any cancelled subscriptions on the same terms and conditions" [E30].

Thus, it was brought home to Herzfeld that Allen, having received the Laventhol report, was satisfied that it sufficiently confirmed the profitable business described in Exhibit B and had determined to go forward with the private placement, replacing any subscription which any investor decided to rescind. And if Herzfeld knowing that Allen, a major investment banking firm, was satisfied with the Laventhol report, why was it essential that he "double

check" Allen. And Laventhol, having convinced Allen, was responsible for consummation of the private placement and Herzfeld's loss.

But we need not rely upon this proof. Plaintiff read the unaudited financials and had been impressed by the deferred profit of \$1,360,000 [320a]. He read the income statement in the Laventhol Report and was reasonably persuaded by the gross profit of \$2,317,687, which included deferred gross profit of \$1,795,500 [E34], that the FGL profit potential was abundantly confirmed.

Laventhol's argument that the "deferred gross profit" of \$1,795,500 was deducted from "Sales", from "gross profit on sales" and from other income items (Br., pp. 22, 39) is an essay in futility. As Herzfeld testified, he understood that the \$1,795,500 was a profit which FGL had earned and would be picked up in a later accounting period. Any sophisticated investor, even an accountant, would understand that an item of deferred gross profit would be subtracted from gross profits and excluded from current earnings—what of it? The statement is misleading because it represents that a profit had been received where the profit, as Laventhol concedes, was highly contingent and unusually uncertain.

Herzfeld's testimony concerning his reliance upon the Income Statement in the Laventhol Report was definite and unequivocal. He testified that when he saw the Laventhol report, he noted "that the auditors were a very fine prestigious firm who I had heard of many times before and I immediately had great confidence in the fact that the certified public accountants were Laventhol, Krekstein, Horwath & Horwath" [E319, E320]. He added [E320]:

"I turned to the income statement and it confirmed the impression I had having read the Firestone report, and knowing the caliber of this firm, Laventhol, this convinced me that I should stay with the investment, because at that time I had the right of rescission".

As Chief Judge Kaufman observed in another connection in *Globus v. Law Research Service, Inc.*, 418 F. 2d 1276 (2d Cir. 1969), "a good name is worth more than a crown" (p. 1285). Certainly, Laventhol's "good name" authenticated Firestone's glittering profitability, as reflected in its gross profits. Herzfeld testified further that when he read Firestone's letter, stating that "the combination of current deferred income is actually higher than projected" [E329], this confirmed the impression he received from the income statement included in the Laventhol report, and "knowing Laventhol to be one of the finest national accountants, I looked no further. I just accepted it" [E324].

We have already reviewed the evidence, relied upon by Laventhol, in support of its claim that had Herzfeld read the qualified opinion and Note 4, he would have understood that "deferred gross profit" did not mean a profit the company had made which it was "going to pick up in a subsequent accounting period"; but a profit, "the realization of which was so uncertain in the minds of the accountants that they qualified their opinion in this regard" (Laventhol, Br., pp. 18, 19). We have shown that the qualification was itself deceptive; and that Note 4 was misleading because it failed to communicate any uncertainty as to the collectibility of the \$4.9 million dollars due from Continental; and on the contrary, by labeling this amount as "Cash", enhanced the impression that its payment was assured which was created by the "deferred profit" label which it put upon the Monterey profit.

In any event, investors are entitled to frank disclosure and not merely to a hint that something may be amiss. It is an eloquent commentary on this doctrine that the English Court of Chancery in 1895 and this Court in 1975 held that an investor is entitled to full disclosure and not merely to information which arouses inquiry (*In re London and General Bank*, 1895, 2 Ch. 673; *Metro-Goldwyn-Mayer v. Ross*, C.C.H. Fed. Sec. L. Rep. ¶94,944 [2d Cir. 1975]).

In *London and General Bank*, an auditor had included in assets on the balance sheet "Loans to customers and other securities", 346,975L, knowing that these assets were in a "very unsatisfactory state". The auditor had commented in respect of these loans and securities, which were the company's most important asset, that "the value of the assets as shown on the balance sheet is dependent upon realization" (p. 685). The Court, holding that the stockholders were entitled to more than a self-evident truism, said (p. 685):

"It is a mere truism to say that the value of loans and securities depends on their realization. We were told that a statement to that effect is so unusual in an auditor's certificate that the mere presence of those words was enough to excite suspicion. But, as already stated, the duty of an auditor is to convey information, not to arouse inquiry, and, although an auditor might infer from an unusual statement that something was seriously wrong, it by no means follows that ordinary people would have their suspicions aroused by a similar statement if, as in this case, its language expresses no more than any ordinary person would infer without it."

Similarly, in *Metro-Goldwyn-Mayer, supra*, where an independent investigation had been made by an auditor retained by plaintiff, and it appeared that the auditor had been provided with data which, if properly interpreted, would have revealed all of the relevant information, the Court held that the duty of disclosure was "not discharged merely by giving the purchaser access to company records and letting him piece together the material facts if he can" (p. 97,259).

Herzfeld testified that even if he had read the qualified certificate, "it would be a meaningless thing to me if they say subject to the collectibility. To me that would be

the same as saying subject to the accuracy of the entire statement" [E337]. Obviously what Herzfeld intended to convey, as the Court of Chancery observed in *London and General Bank*, was that the value of receivables always depends on their collectibility, just as the value of loans and securities "depends on their realization"—this "is a mere truism" which might be significant to an auditor but "expresses no more than any ordinary person would infer without it".

To paraphrase Judge Friendly in *U.S. v. Benjamin*, *supra*, "It would be insulting an honorable profession to suppose that a certified public accountant" may include a \$15.3 million dollars transaction in "sales" and record a profit, current and deferred, of \$2,030,500, and "justify the meaningless result simply by an applique" of an ambiguous phrase in the certificate (p. 861). The phrase "pro forma", employed in *Benjamin*, is no more exculpatory than the phrase "subject to collectibility" in this case.

Appellant states repeatedly that Herzfeld was a sophisticated, experienced investor—as such, he had a right to conclude, that deferred profit is exactly what it means in the dictionary and in elementary accounting texts—a profit received but not yet earned.

But in any event, "the cases are replete with instances in which sophisticated investors" have recovered under the Securities Acts (*Johns Hopkins University v. Hutton*, 297 F. Supp. 1165, 1217, *aff'd* 422 F. 2d 1124 [4th Cir. 1970]); and it is the function of the Securities Acts to impose upon the sellers of securities the obligation of full disclosure—thus, it is ruled that the Securities Act "relieves the purchaser from the common law obligation of using reasonable prudence" (*Murphy v. Cady*, 30 F. Supp. 466, 469 [D. Me. 1939], quoted in *Johns Hopkins University v. Hutton*, *supra*; and see, *Athas v. Day*, 161 F. Supp. 916, 918-919 [D. Colo. 1958]; *Restatement of Torts*, §538, Comment on Subsection 3-K and §540; *Dale v. Rosenfeld*, 229 F. 2d 855

[2d Cir. 1956]; *Wilko v. Swan*, 346 U.S. 427, 431, 98 L. Ed. 2d 168; *Hughes v. Securities & Exchange Commission*, 174 F. 2d 969, 976 [D.C. Cir. 1949]; *Kaiser-Frazer Corp. v. Otis & Co.*, 195 F. 2d 838, 843-844 [2d Cir. 1952].

In *Hutton*, the Court stated (p. 1221):

"The defenses of contributory negligence or of assumption of risk, however, are not available to a defendant at common law with regard to actions of deceit, and certainly are not available to a defendant under Section 12(2) of the '33 Act."

Even in mail fraud cases, it has been held that "the monumental credulity of the victim is no shield for the accused" (*Deaver v. U.S.*, 155 F. 2d 740, 744-745 [D.C. Cir. 1946], cert. den. 329 U.S. 766, quoted in 3 Loss, *Securities Regulation*, p. 1438). Similarly, it is said the securities laws "were enacted for the very purpose of protecting those who lack business acumen", 6 Loss, *Securities Regulations Supp.*, p. 3546; and as the Court said in *Texas Gulf Sulphur Co.*, 401 F. 2d 833, 849 (2d Cir. 1968):

"Speculators and chartists . . . are also reasonable investors entitled to the same legal protection afforded conservative traders" (*id.*, p. 3547).

On this point, the Court in *Myzel v. Fields*, 386 F. 2d 718 (8th Cir. 1967) quoted from Prosser, *Torts*, §103 (3d Ed. 1964):

"The design of the law is to protect the weak and credulous from the wiles and stratagems of the artful and cunning, as well as those whose vigilance and security enable them to protect themselves,' and 'no rogue should enjoy his ill-gotten plunder for the simple reason that his victim is by chance a fool.'" (p. 736).

Certainly, if credulity and uncritical confidence is not a defense in common law fraud, it is of no avail in a 10b-5

case where the overriding policy is encouragement of "vigorous enforcement of the securities law through private litigation" (*Chris-Craft, supra*, p. 357).

But here, there was no occasion for credulity or uncritical confidence. The Monterey transactions were included in sales and in gross profits—a description of a portion of the profit as "deferred" did not communicate to the investors that it had not been realized. And the fact that the payment not due until January, 1970, was described as cash simply added to the impression that the Monterey transactions were consummated and that the profit had been realized.

Laventhol knew that this statement was false—its earlier "superseded" report of "unrealized income" was correct. But Firestone would have none of it—and Laventhol yielded to the threats which have been described.

POINT III

Laventhol Knowingly Submitted a Misleading Report —in Any Event, Actionable Misconduct Under Rule 10b-5 Was Overwhelmingly Established.

The test of actionable misconduct under Rule 10b-5 was set forth in *Cohen v. Franchard Corp.*, 478 F. 2d 115, 123 (2d Cir., 1973):

"The standard for determining liability under Rule 10b-5 essentially is whether plaintiff has established that defendant either knew the material facts that were misstated or omitted and should have realized their significance, or failed or refused to ascertain and disclose such facts when they were readily available to him and he had reasonable grounds to believe that they existed. See *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, *supra*, 480 F. 2d at 363, slip op. at 4932-33."

In *Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F. 2d 341, 356 (2d Cir. 1973), the Court described the scienter requirement as follows (pp. 356-357):

"... The scienter requirement in a Rule 10b-5 private damage action appears to have been reduced to a knowledge of falsity or reckless disregard for the truth standard by our decisions in *Heit v. Weitzen*, 402 F. 2d 909, 914 (2 Cir. 1968), cert. denied, 395 U.S. 903 (1969), and *Globus v. Law Research Service, Inc.*, 418 F. 2d 1276, 1290-91 (2 Cir. 1969), cert. denied, 396 U.S. 913 (1970), 'to insure the maintenance of fair and honest markets in . . . [securities] transactions.' Section 2 of the 1934 Act, 15 U.S.C. §78b (1970)."

The Court added that this lowering of the scienter requirement was prompted "in substantial part for uniform policy of encouraging vigorous enforcement of the securities laws through private litigation" (p. 357).

In *Lanza v. Drexel & Co.*, 479 F. 2d 1277 (2d Cir. 1973), the Court defined the standards as follows (p. 1306, n. 98):

"In determining what constitutes 'willful or reckless disregard for the truth', the inquiry normally will be to determine whether the defendants knew the material facts misstated or omitted, or failed or refused, after being put on notice of a possible material failure of disclosure, to apprise themselves of the facts *where they could have done so without any extraordinary effort.*" (Emphasis supplied.)

Certainly, it would not have required "extraordinary effort" for Chazen and Lipkin to take a half-hour taxi ride to Borah's office, show him the contracts, and obtain his considered legal opinion as to the significance of the Monterey contracts. Nor would it have involved much time or effort to secure a written confirmation from Ruderian acknowledging that he had a fixed obligation to pay \$5,015,250

and that funds were committed for this payment. When Laventhol accepted uninformed statements by Borah and glib assurances from Ruderian, it failed to ascertain the facts where it "could have done so without any extraordinary effort".

The language of the Court in *Escott v. Barchris Construction Corp., et al.*, 283 F. Supp. 643 (S.D.N.Y., 1968) is particularly apt here. The Court, holding defendant PMM liable for the issuance of a false financial statement, found that "(m)ost important of all, he [the partner in charge] was too easily satisfied with *glib answers to his inquiries*" (p. 703) (emphasis supplied).

The Court added that "there were enough danger signals in the materials which he did examine to require some further investigation on his part. Generally accepted accounting standards required such further investigation under these circumstances. It is not always sufficient merely to ask questions" (p. 703).

The "danger signals", which the Court held sufficient to have required further investigation in *Barchris*, were far more glaring here. A \$15.4 million dollar purported sale appears for the first time in the last week of the accounting period; was never on the books; was not known to principal officers of the company; was never the subject of a directors' meeting; and the contracts for both buyer and seller were prepared by a layman employee of FGL on printed forms. These were not merely danger signals—they were blazing red lights which should have alerted Laventhol to make the most thorough-going investigation—phone calls were simply not enough.

Particularly apt here is the ruling of the Court in *Simon supra*, that the jury could infer that "the striking difference between what Note 2 said and what it needed to say in order to reveal the truth resulted not from mere carelessness, but from design" (p. 810).

Here too, the District Court had a right to conclude that the "striking differences" between what Note 4 said and what it should have said resulted not from carelessness but from a purpose to mislead the investors. Had Laventhol stated in Note 4, as it was required to do if the truth were to be told, that the purchaser of the Monterey properties was a corporation with a net worth of \$100,000, represented by miniature golf courses; that the transaction would not close unless Ruderian resold the property; and that the contracts might be options, not transactions of purchase and sale, it is safe to say that the enthusiasm of Allen and the investors would have been quickly chilled, and the private placement would not have gone forward.

Also pertinent here is the finding in *Simor* that defendants could be held criminally responsible for their failure to report an increase in a receivable from \$3.4 to \$3.9 million dollars, where the facts justified an inference that the non-disclosure "was part of an effort to create an appearance of collectibility which defendants knew to be false" (p. 808). Laventhol knew that Continental could not pay \$4.9 million dollars—yet the reference in its certificate to the fact that its opinion was "subject to the collectibility" of this \$4.9 million dollar obligation, plainly implied that Laventhol had no knowledge that an obligation to pay \$4.9 million dollars was not collectible from a corporation whose net worth was \$100,000.

Though this Court has made clear that "something short of specific intent to defraud is required and something more than mere negligence" (*Republic Technology Fund, Inc. v. Lionel Corp.*, 483 F. 2d 540, 551 [2d Cir. 1973]), it is not necessary here to inquire into this undefined area of culpability; or to undertake to demonstrate the "willful or reckless disregard for the truth" which has been considered to be a "prerequisite" (*Lanza v. Drexel & Co.*, 479 F. 2d 1277, 1306 n. 98 [C.A. 2d 1973]). On this

record, the proof overwhelmingly establishes common law fraud in its most culpable form.

It is ancient learning that silence, where there is "a positive duty to speak" is "common law deceit" (*U.S. v. Groves*, 122 F. 2d 87, 90, Clark, C.J. [C.A. 2d 1941]).

Here, Laventhol had a clear duty to disclose to the investors the material facts within their knowledge concerning the profitability or lack thereof of the enterprise; and their withholding of these facts was a "material concealment" from the investors.

The "superseded" Report conclusively brings home to Laventhol knowledge that there was no "deferred" profit attributable to the Monterey transactions; that the \$1,795,500 was in fact "unrealized"; and that the accounting principle which governs the treatment of income received before it is earned has not the remotest application to the Monterey transaction, where it cannot possibly be suggested that FGL had received income to be earned in the future. In fact, Laventhol admits that the deferred gross profit of \$1,795,500 was subject to "unusual uncertainties as to the effect of future developments" (Br., p. 34)—how therefore can it be suggested that the profit had already been received? Laventhol's culpability therefore in switching labels from "unrealized" to "deferred" could not be more clearly established.

Moreover, in "individual suits to recover personal damages", where "face-to-face confrontations" are involved, it is appropriate that "courts should enforce a higher standard of disclosure by lessening the degree of culpability upon which the liability can be enforced" (*Kohn v. American Metal Climax*, *supra*, at p. 286; *Ellis v. Carter*, 291 F. 2d 270 [9th Cir. 1961]; *Royal Air Properties v. Smith*, 312 F. 2d 210 [9th Cir. 1962]; *Stevens v. Vowell*, 343 F. 2d 374 [10th Cir. 1965]; and *Myzel v. Fields*, 386 F. 2d 718 [8th Cir. 1967]).

The law is well settled that the defendant "cannot avoid liability by pleading ignorance where his knowledge and experience tell him that certain events or circumstances known to him require that further inquiry be made" (*Chris-Craft Industries, Inc. v. Piper Aircraft Corp.*, 480 F. 2d 341 [2d Cir. 1973]). It must be evident that Laventhol had seen "the seagulls on the water" and had ignored them (*Lanza, supra*, at p. 1321).

Here, the seas were crowded with seagulls as far as the horizon. The multi-million dollar Monterey transaction, involving more than a score of nursing homes in various parts of the United States, suddenly appears 11 days after the Note and Stock Purchase Agreement, which is dated November 10, 1969 and which has annexed to it the fictional Schedule B; on November 20, 1969, according to Lipkin, Firestone called him from a bar to discuss with him a fictitious or artificial real estate transaction and the accounting treatment which would be given to it; on November 21, 1969, an internal memorandum is written which could only refer to the Monterey transaction and which describes it as involving a \$10 million dollar purchase by Firestone. This purchase, stated to have been already made, becomes a \$13.4 million dollar purchase on the following day; and, the selling price climbs from \$11.4 million a few days later to \$15.4 million.

Here, there was much more than the danger signals referred to in *Barchris*, 283 F. Supp. 643, page 703. Laventhol should have been alerted to make the most thoroughgoing investigation—telephone calls to Borah or to Ruderman were whistling in the wind.

In *Chris-Craft, supra*, the Court observed that the function of the *scienter* requirement is to limit liability "to those whose conduct has been sufficiently culpable to justify the penalty sought to be exacted"; and that since the policy behind the Securities Laws in general and the anti-fraud provisions in particular, is the protection of investors who

rely on the completeness and accuracy of information made available to them, persons with greater access to information or having a special relationship to investors making use of the information have an "affirmative duty of disclosure" (*Chris-Craft, supra*, p. 363). Since it is obvious that independent auditors, employed precisely for the purpose of preparing an audited report to be used in selling securities, have "greater access to information" and "a special relationship to investors making use of the information", the affirmative duty of disclosure could not be more completely established.

Under these circumstances, accountants "are required to ascertain what is material as of the time of the transaction and to disclose fully "those material facts about which the investor is presumably uninformed and which would in reasonable anticipation affect his judgment' . . . a knowing or reckless failure to discharge these obligations constitutes sufficiently culpable conduct to justify a judgment under Rule 10b-5 or Section 14E for damages" (p. 363).

Essentially, the "law was aimed at misrepresentations or omissions involving some degree of awareness on the part" of the defendant charged. Accordingly, the scienter requirement is satisfied "upon a showing that the person charged knew the material facts misrepresented or omitted and could reasonably have been expected to appreciate their significance . . . or if he did not know them, that he had reasonable cause to believe that there might be a material failure in disclosure and yet did not ascertain and disclose the facts even though he could have done so without any undue effort" (p. 398).

Here, no effort at all was required—Laventhol knew the facts and failed deliberately to disclose them. Upon this proof, its scienter is conclusively demonstrated.

POINT IV

Laventhol Is Liable for Common Law Fraud.

The test of liability of accountants for common law fraud is well settled (*State Street Trust Co. v. Ernst*, 278 N.Y. 104, 112 [1938]):

" . . . A representation certified as true to the knowledge of the accountants when knowledge there is none, a reckless misstatement, or an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth, are all sufficient upon which to base liability. A refusal to see the obvious, a failure to investigate the doubtful, if sufficiently gross, may furnish evidence leading to an inference of fraud so as to impose liability for losses suffered by those who rely on the balance sheet. In other words, heedlessness and reckless disregard of consequence may take the place of deliberate intention."

And, as Chief Judge Cardozo wrote in *Ultramares v. Touche*, 255 N.Y. 170, 190, 191 (1931)

"In this connection we are to bear in mind the principle already stated in the course of this opinion that negligence or blindness, even when not equivalent to fraud, is none the less evidence to sustain an inference of fraud. At least this is so if the negligence is gross."

The doctrine of *Ultramares* and *Ernst* was not new law in the '30's when these cases were decided—Holmes long ago pointed out that fraud is shown "if the representation is made recklessly without knowing whether it is true or false" (*Common Law*, pp. 135, 136); and where a statement is made on data known to be insufficient, the

defendant is liable "whatever was the state of his mind, and although he individually may have been perfectly free from wickedness in making it" (p. 136).

Furthermore, apart from grossly negligent misrepresentations, it is also settled law that "Silence, when there is a duty to speak, can itself be a fraud" (*S.E.C. v. Texas Gulf Sulphur Co.*, 401 F. 2d 833 [2d Cir. 1968]; *S.E.C. v. Great American Industries, Inc.*, 407 F. 2d 453, 461 [2d Cir. 1967]; *U.S. v. Groves, supra*).

Inherent in the concept of an *independent* accountant is its obligation to the public investor. The requirement of the securities act which requires certification by independent public or certified accountants has no other significance. This fundamental proposition is recognized by accountants (*Responsibilities and Liabilities of Auditors and Accountants, An Accountant's View*, Henry P. Hill, C.P.A., American Bar Association, National Institute on Advisors to Management; Responsibilities of Lawyers and Accountants, October 3-5, 1974). As Mr. Hill points out, the principal categories covered by the rules of conduct embodied in the Code of Professional Ethics are "independence, integrity and objectivity".

As such, the accountant has a "duty to speak," failure in which constitutes common law fraud.

We have shown that the record goes far beyond "gross negligence" and the proof of material non-disclosure is incontrovertible. Laventhol had knowledge that the Monterey transactions were "highly contingent", "unusually" uncertain—and this is an understatement in the context of a transaction dependent upon the payment of \$4.9 million dollars by a corporation with \$100,000 in net assets. Laventhol therefore had positive knowledge that the \$4.9 million dollars receivable was not collectible—no such knowledge was conveyed to the investor.

Laventhol's principal defense is the telephone conversations with Ruderian and Borah, which it strangely char-

acterizes as "quite extraordinary steps" (Laventhol Br., p. 50). This Court has recently had occasion to comment on the inadequacy of verifications conducted "in a rather haphazard manner by telephone" (*U.S. v. Nastelli*, Fed. Sec. L. Rep. [1975] ¶95,250, p. 98,294); and also observed that "no indication is given" in the footnote to the flimsy nature of the evidence relied upon by the accountants.

Here, the verifications were more than merely "loose and haphazard"; they were wholly meaningless. To regard the soliciting of a legal opinion over the telephone on the basis of contracts unseen by the attorney as a verification of anything is "insulting to an honorable profession" (*U.S. v. Benjamin*, *supra*, p. 51); and the acceptance of Ruderian's "glib assurances" over the telephone is similarly worthless. Upon the record, Laventhol's liability in common law fraud was clearly established.

POINT V

Laventhol Was Liable for Violating Section 352-c of the General Business Law.

Under Section 352-c of the General Business Law, it is a misdemeanor to engage in fraud or misrepresentation in the issuance or distribution of securities, and as the District Court pointed out, the purpose of the statute, essentially identical with the objective of the federal securities acts, "is to protect the public against fraud in the sale of securities" (213a; *Herdegen v. Paine, Webber, Jackson & Curtis*, 31 Misc. 2d 104 [Sup.Ct. 1961]).

The New York courts have consistently held that a private cause of action exists for violation of the statute resulting in damage to plaintiff (*Barnes v. Peat, Marwick, Mitchell & Co.*, 69 Misc. 2d 1068 [N.Y.Co. 1972], *aff'd* 42 A D 2d 15 [1st Dept. 1973]). The Federal courts have rendered similar decisions: *Lupardo v. I.N.M. Indus.*

Corp., 36 F.R.D. 438 (S.D.N.Y. 1965); *American Bank & Trust Co. v. Barad Shaff Sec. Corp.*, 335 F Supp 1276, 1283 (S.D.N.Y. 1972); cf. *Briskin v. Glickman*, 276 F. Supp. 600 (S.D.N.Y. 1967).

The same considerations of policy which prompted the Federal courts to encourage the enforcement of the securities acts by private litigation are applicable here (*supra*, p). Affirmance of this doctrine here is not only consistent with these authorities, but to the extent that it reaffirms the existence of a state remedy, the resulting encouragement of enforcement of securities frauds in the state courts would lighten the burden imposed upon the Federal judiciary and therefore seems clearly desirable as a matter of policy.

CONCLUSION

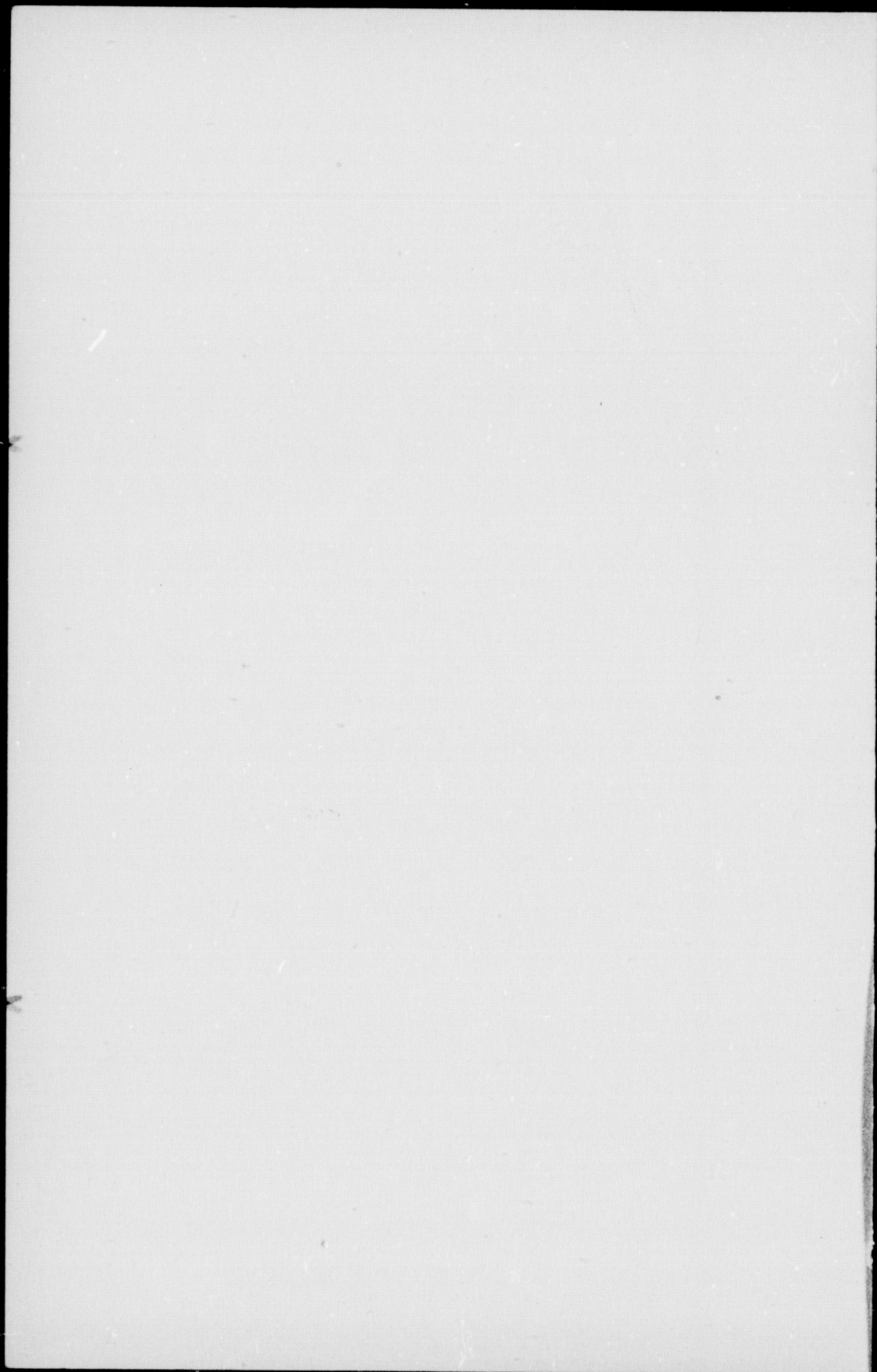
The special obligation of persons engaged in a public calling has been recognized from earliest times. Holmes, *The Common Law* (p. 184), describes the "obligation of those exercising a public or 'common' business to practice their art on demand and show skill in it"; and he quotes from Fitzherbert that "it is the duty of every artificer to exercise his art rightly and truly as he ought'" (F.N.B. 94d).

We have shown that Laventhol knowingly failed to discharge its obligation in this case to plaintiff's detriment. The judgment below should be affirmed.

Respectfully submitted,

BLUM, HAIMOFF, GERSEN, LIPSON & SZABAD
Attorneys for Plaintiff-Appellee

LOUIS HAIMOFF,
Of Counsel.



STATE OF NEW YORK)
COUNTY OF NEW YORK) ss.:

JORGE GONZALEZ, being duly sworn,
deposes and says that deponent is not a party to the action,
is over 18 years of age and resides at 233 WEST 15TH ST
NEW YORK, N.Y.

That on the 8th day of OCTOBER, 1975,
deponent personally served the within BRIEF OF GERALD L. HERZFELD
PLAINTIFF - APPELLEE
upon the attorneys designated below who represent the
indicated parties in this action and at the addresses below
stated which are those that have been designated by said
attorneys for that purpose.

By leaving 2 true copies of same with a duly
authorized person at their designated office.

~~By depositing true copies of same enclosed~~
~~in a postpaid properly addressed wrapper, in the post office~~
~~or official depository under the exclusive care and custody~~
~~of the United States post office department within the State~~
~~of New York.~~

Names of attorneys served, together with the names
of the clients represented and the attorneys designated
addresses.

WILLKIE FARR & GALLAGHER
ATTORNEYS FOR APPELLANT LAVENTHOL
ONE CHASE MANHATTAN PLAZA
NEW YORK, N.Y. 10005 ATTN: MRS. HALBROCK

POLLACK & SINGER, ESQS
ATTORNEYS FOR APPELLANT ALLEN
61 BROADWAY
NEW YORK, N.Y. 10006

Sworn to before me this

8th day of October, 1975

Jorge A. Gonzales

Michael DeSantis
MICHAEL DeSANTIS
Notary Public, State of New York
No. 03-0930908
Qualified in Bronx County
Commission Expires March 30, 1978